LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Amidst a backdrop of supportive monetary policy, the reach for yield was evident in risk assets globally. Domestic investment grade corporate bonds were further buoyed by seasonal cash flows, anecdotal evidence of increased liability-driven investment strategies of defined pension plans, and the typical increase in investor risk appetite at the outset of a new year. As a result, domestic investment grade spreads tightened by 10 basis points on average in the first quarter. The move can be most aptly described as aggressive as investors extended, both out the credit curve and the credit spectrum.

Positive market tone and dynamics were supportive for primary market activity, resulting in a robust $21.6 billion coming to market during the quarter. Issuance was dominated by the banks ($11.8 billion), real estate ($1.9 billion), cable ($1.6 billion) and autos ($1.4 billion). The flurry of small real estate deals (thirteen in total) were particularly notable, as some unsecured issues came at levels near or through where secured funding could be placed with banks. Characteristically, the majority of new issues were heavily oversubscribed and, with a few notable exceptions, performed well in secondary trading.

For the quarter, short, mid and long-term corporate yield spreads tightened by 9, 14 and 9 basis points respectively, resulting in absolute returns of 1.39%, 3.85% and 6.06% respectively according to the FTSE TMX Canada All Corporate Bond Index. Spread compression was greatest in the middle part of the credit curve as a result of the high concentration of BBB issues (comprising roughly half of all mid-term corporates). On an absolute basis, overall returns were predominately driven by the bull flattening of the underlying government yield curve – longer term yields fell by more than shorter-term yields.

The best spread and absolute performance, across the yield curve, was reserved for lower rated, higher yielding sectors: real estate in the short-end, and retail, media/telecom in the mid and long ends. Subordinated bank/insurance and *holdco* issues also performed well across the curve due to the higher yield that structurally subordinate debt provides. Alternatively, more defensive, higher rated issues in regulated pipelines, utilities and infrastructure underperformed. Relative performance on a rating basis reflected the investor posture toward risk, as lower-rated BBB debt outperformed across the credit curve.

Portfolio Activity

The recapitalization of Tim Horton's pressured its spreads and the opportunity was taken to add the name to the portfolio. A position in pipeline *opco* debt was sold, increasing overall yield, while maintaining the portfolio's duration and yield curve bias for rising rates and a steepening yield curve.

What Worked In The Quarter

The portfolio was overweight in telecom, banks and retail which were among the top performing sectors for the quarter.

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter duration and an overweight in the belly (5-10 year) of the yield curve in lieu of long bonds. For the quarter, underlying 5, 10 and 30 year government yields fell by 25, 31, and 27 basis points respectively.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade. We feel that the insatiable demand for credit witnessed during the quarter may have more *legs* and as a result investors have increasingly become complacent on a risk/reward basis in their reach for yield.

From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak; however in the short-term we do not expect any significant degradation in the general quality of credit as corporate fundamentals, which, in terms of leverage, liquidity and profitability still remain sound. We do feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening through a rotation into equities or a significant deviation from conservative corporate policies.

That said, the portfolio is structured conservatively and, additionally, has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. We, therefore, are well positioned to capitalize on relative value and yield enhancement.

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